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Supreme Court of the United States

OCTOBER TERM, 1934

No. [redacted] 8

JAMES C. COLGATE,

Appellant,

vs.

ERWIN M. HARVEY, Tax Commissioner of the State of Vermont,

Appellee.

APPEAL FROM THE SUPREME COURT OF THE STATE OF VERMONT.

APPELLANT'S BRIEF.

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SUBJECT INDEX.

		PAGE
(a)	Index of Cases cited	
	Index of Statutes cited	
(b)	Opinions below	1
(c)	Grounds on which jurisdiction of this Court is invoked	1
(d)	Statement of the Case	1
	Preliminary Statement of Questions Involved	1
	History of the Case	2
	The Statute	3
	Facts	6
(e)	Assigned errors intended to be urged	7
(f)	Argument	10
	Summary	10
	POINT I. Public Act No. 17 in effect taxes interest and dividends earned outside of Vermont and exempts interest and dividends earned within Vermont. It is therefore unconstitutional under the Fourteenth Amendment of the United States Constitution	11
	Subd. 1. The Statute is *prima facie* unconstitutional	11
	Subd. 2. The attempted justifications do not sustain the Statute	20
	POINT II. Public Act No. 17, by discriminating against investment by Vermont residents in non-Vermont stocks and loans, in effect creates an embargo upon the export of capital. It is therefore unconstitutional under the Commerce Clause, Article I, Section 8, of the United States Constitution	27

PAGE

POINT III. The taxes involved cannot stand if the discriminatory exemptions are stricken from the statute as unconstitutional 28

POINT IV. Public Act No. 17, by arbitrarily refusing to the appellant the $800. exemption given to other persons whose situation differed from his only in that they had no income from business, denies the appellant the equal protection of the laws. It is therefore unconstitutional under the Fourteenth Amendment of the United States Constitution 29

CONCLUSION. The judgment of the Supreme Court of Vermont should be reversed and the cause remanded with instructions to annul the assessment of the appellant's tax and to cause the same to be refunded to him..... 31

(a) Index of Cases Cited.

PAGE

Bethlehem Motors Corporation v. *Flynt*, 256 U. S. 421 ..... 21, 26
Borden's Company v. *Baldwin*, 293 U. S. 194 20

Chalker v. *Birmingham & Northwestern Railway Co.*, 249 U. S. 522 ..... 14, 16
Citizens' Telephone Co. v. *Fuller*, 229 U. S. 322 25

Darnell v. *Indiana*, 226 U. S. 390 ..... 17, 18

First National Bank v. *Maine*, 284 U. S. 312 27

General American Tank Car Corporation v. *Day*, 270 U. S. 367 26

Hamilton v. *Regents*, 293 U. S. 245 14
Hanover Insurance Co. v. *Harding*, 272 U. S. 492 ... 12

Kidd v. *Alabama*, 188 U. S. 730 26
Klein v. *Board of Supervisors*, 282 U. S. 19 .....23, 24, 25

Lawrence v. *State Tax Commission*, 286 U. S. 276... 28
Louisville Gas & Electric Co. v. *Coleman*, 277 U. S. 32 .....12, 20, 30, 32

New Jersey Telephone Co. v. *Tax Board*, 280 U. S. 338 28
Northwestern Life Ins. Co. v. *Wisconsin*, 247 U. S. 132 28

Royster, F. S., Guano Co. v. *Virginia*, 253 U. S. 412 ..... 18, 20, 30

Sharon v. *Hill*, 26 Fed. 337 14

Travellers' Insurance Co. v. *Connecticut*, 185 U. S. 364 26

Statutes Cited.

	PAGE
Constitution of the United States	7
Article 1, Section 8	7, 8, 9, 27
Article 4, Section 2	7, 14, 15, 16
14th Amendment	7, 8, 9, 11, 12
Judicial Code, Section 237a, as amended by the Act of January 31, 1928, Chapter 14 (45 Stat. 54), and the Act of April 26, 1928, Chapter 440 (45 Stat. 466)	1, 3
Public Act No. 17 of the Public Acts of 1931 of the State of Vermont, known as the "Income and Franchise Tax Act of 1931" pages 17-46 inclusive of the official edition of "Acts and Resolves passed by the General Assembly of the State of Vermont at the Thirty-first Biennial Session"	1, 2, 3
Part I, Section 3, Par. First	3, 29
Second, Subd. a	4, 6, 11, 29
Second, Subd. d	4, 7, 11
Second, Subd. e, Second	4, 5, 7, 30
Section 26	2, 31
Section 27	2
Part II, Section 2	5, 6, 11
Section 3	5, 6, 11

(b) OPINIONS BELOW.

The County Court of Washington County, Vermont handed down no opinion.

The Supreme Court of Vermont handed down an opinion (R. 16-25) which has not yet been officially reported. It is, however, reported as *Colgate* v. *Harvey*, 175 Atl. 352.

(c) GROUNDS ON WHICH JURISDICTION OF THIS COURT IS INVOKED.

A statement as to the jurisdiction of this Court has already been filed in compliance with paragraph 1 of Rule XII and probable jurisdiction was noted by this Court on April 1, 1935.

(d) STATEMENT OF THE CASE.

Preliminary Statement of Questions Involved.

This is an appeal under Judicial Code, Section 237, Subdivision (a), from a judgment of the Supreme Court of the State of Vermont, upholding the validity of Public Act No. 17 of the Public Acts of 1931 of the State of Vermont, known as the "Income and Franchise Tax Act of 1931".

The appellant, a citizen and resident of Vermont, during the year 1931 received interest upon money loaned outside of the State of Vermont at rates of not more than 5% per annum and received dividends upon the stock of corporations doing business outside of the State of Vermont. Under the Act in question an income tax of 4% was imposed upon such interest and upon a part of such dividends proportionate to the income of the corporations earned outside the State of Vermont. At the same time those who received interest upon money loaned *within* Vermont at not more than 5% per annum or dividends from stock of corporations doing all of their business *within* Vermont were

not required by the said statute to pay any income tax. In this respect the statute is challenged as discriminatory and invalid because contrary to the provisions of the United States Constitution which forbid the states to abridge the privileges and immunities of citizens of the United States, to deprive any person of life, liberty or property without due process of law or to deny to any person within their jurisdiction the equal protection of the laws, and contrary to those provisions which vest in Congress the exclusive power to regulate commerce among the several states.

The statute is also attacked as discriminatory in that it deprived the appellant of the benefit of an exemption of $800. which was given to persons who, unlike him, derived all of their income from investments and received none from any business.

History of the Case.

The appellant filed his individual income tax return for the calendar year 1931, indicating a tax payable under the terms of said Public Act No. 17 of 1931, amounting to $7,176.13 (R. 6A-6B), accompanied by a payment of one-quarter of the tax indicated thereby, and his written protest against the requirement of such return and the collection of such tax, upon the constitutional grounds above outlined and other grounds (R. 7).

On August 27, 1932, pursuant to the statute (Public Act No. 17 of 1931, Sec. 26, Pt. I) he made application to the Commissioner of Taxes for a revision of such tax (R. 8-13) which resulted in a decision of the Tax Commissioner confirming the correctness of the tax indicated by the return (R. 13).

On March 1, 1933, pursuant to the statute (Sec. 27, Pt. I), he brought his petition to the Washington County Court of the State of Vermont for relief upon the constitutional grounds above outlined among others (R. 3-5). This petition was heard on an agreed statement of facts (Stipula-

tion, R. 14) which comprehended all matters of fact alleged in the application for revision and in the petition, and added the fact of the payment of the full tax under protest (R. 14).

This resulted on February 15, 1934, in a judgment of the Washington County Court upholding the Tax Commissioner without opinion (R. 14).

The appellant took the case to the Supreme Court of Vermont on exceptions, raising the constitutional questions above outlined among others (R. 1, 3, 15-16), and on November 7, 1934, the judgment of the Washington County Court was unanimously affirmed (R. 16). The Vermont Supreme Court rendered an opinion printed at pages 16-25 of the Record, and reported at 175 Atl. 352, expressly passing upon all of the constitutional questions above outlined.

The appellant has brought the case to this Court by appeal under Judicial Code Section 237, Subdivision (a), as amended, and this Court on April 1, 1935, noted probable jurisdiction.

The Statute.

Public Act No. 17 of the Public Acts of 1931 of the State of Vermont, known as the Income and Franchise Tax Act of 1931, may be found at pages 17-46, inclusive, in the official edition of "Acts and Resolves Passed by the General Assembly of the State of Vermont at the Thirty-First Biennial Session". The pertinent provisions of the said statute are here set out *verbatim* as follows:

Part I.

"Sec. 3. *Rate; Exemptions; Amount.*—A tax is hereby imposed upon every resident of the state, which tax shall be levied, collected and paid annually, with respect to

"First, his net income as herein defined, after deducting the exemptions provided in this act, at the rate of two per cent; and

"Second, to the income received by him on account of the ownership or use of or interest in any stock, bond, note, agreement or other interest bearing security at the rate of four per cent; provided, however, that the words 'income received by him on account of the ownership or use of or interest in any stock, bond, note, agreement or other interest bearing security' shall not include the following items, which shall be exempt from taxation under this act:

"(a) Interest received on account of money loaned within this state, at a rate of interest not exceeding five per cent per annum evidenced by a promissory note, mortgage on real estate or a bond for a deed, including credits representing the purchase price, or any part thereof, of real estate within this state, sold or transferred, evidenced by a promissory note, mortgage or bond for a deed bearing a rate of interest not exceeding five per cent per annum;

* * * * * * * *

"(d) Dividends on stocks of those corporations which are subject to taxation under Part II of this act; provided, however, that if a corporate franchise tax is not measured by the entire net income of such corporation, then a portion of the dividends paid by such corporation shall be taxable under Part I of this act, and such taxable portion shall be that proportion of the dividend as the income earned by the corporation from business done without the state of Vermont bears to the entire income of the corporation.

"Such taxes shall first be levied, collected and paid in the year 1932 and with respect to the net income received during the calendar year 1931 or during any income year ending during the twelve months ending March 31, 1932.

"(e) In case the income taxed in this section is derived wholly from ownership of or interest in any stock, bond, note or other interest bearing security, there shall be deducted from such income the following exemptions:

"First: In case of a single individual a personal exemption of $400.

"Second: In the case of the head of a family, or a married individual living with husband or wife, a personal exemption of $800; but if either a husband or wife shall receive any income other than that derived from the ownership of or interest in any stock, bond, note or other interest bearing security, then such personal exemption shall not be allowed. A husband and wife living together shall receive but one personal exemption of $800 against their aggregate net income; and in case they make separate returns, the personal exemption of $800 may be taken by either or divided between them" (pp. 18 and 19).

* * * * * * * *

Part II.

"Sec. 2. *Rate.*—For the privilege of exercising its franchise in this state in a corporate or organized capacity, every domestic corporation, and for the privilege of doing business in this state every foreign corporation, liable to tax under this act shall annually pay to this state for the privilege of carrying on or doing business by it within this state, a franchise tax to be measured by its net income to be computed in the manner hereinafter provided at the rate of two per cent upon the basis of its net income as herein computed for the next preceding fiscal or calendar year.

"Sec. 3. *Basis on business within the state.*—If the entire business of the corporation be transacted within the state the tax imposed shall be based upon the entire net income of such corporation for such fiscal or calendar year. If the entire business of the corporation be not transacted within the state and its gross income derived from business done both within and without the state, the determination of its net income shall be based upon the business done within the state and for the purpose of computing such net income the commissioner of taxes shall adopt such recommendations and regulations for the allocation of net income as will fairly and justly reflect the net income of that portion of the business done within the state" (p. 37).

Facts.

James C. Colgate, the appellant, is a natural born citizen of the United States. He was throughout the year 1931 a married individual, living with his wife, who derived income from the ownership of or interest in stocks, bonds, notes and other interest bearing securities and otherwise (R. 8, 12). He seasonably filed an individual income tax return for the calendar year 1931, showing a tax of $7,176.13, accompanied by payment of one-quarter of the tax indicated thereby, and a written protest against the requirement of the return and the collection of the tax (R. 8, 6A, 6B, 7). He subsequently paid the balance of said tax under like protest (R. 14).

Included in this tax of $7,176.13, there was a tax of $1,037.80 computed at the rate of 4% on income amounting to $25,945., received by the appellant in the year 1931, as interest on account of money loaned without the State of Vermont at rates of interest not exceeding 5% per annum, upon bonds, notes and other obligations of the classes enumerated by said Public Act No. 17, in Part I, Sec. 3, Par. Second, Subd. (a) thereof, quoted at p. 4, *supra* (R. 8, 9).

The appellant deemed himself aggrieved because it was provided in said subdivision of Public Act No. 17, that no tax was imposed upon amounts received as interest on account of money so loaned within the State of Vermont bearing interest at rates not exceeding 5% per annum and evidenced by such obligations (R. 10).

There was also included in said tax of $7,176.13 a tax of $6,272.81 computed at the rate of 4% on income amounting to $130,875.39, received by the appellant in the year 1931, as dividends, or fractions thereof, on stocks of corporations the income of which, or like fractions thereof, was not subject to taxation as against said corporations at the rate of 2% under Part II of said Public Act No. 17, because earned *without* the State of Vermont (R. 8, 9, 13. Pt. II of the Act quoted at p. 5, *supra*).

The appellant deemed himself aggrieved because it was provided in said Public Act No. 17, in Part I, Sec. 3, Par. Second, Subd. (d), quoted at p. 4, *supra,* that no tax was imposed upon amounts received as dividends, or fractions thereof, on stocks of corporations the income of which, or like fractions thereof, was subject to taxation as against said corporations at the rate of 2% under Part II of said Act, because earned *within* the State of Vermont (R. 8, 9, 13).

There was also included in said tax of $7,176.13 a tax at the rate of 4% per annum on $800. of income derived from the appellant's ownership of and interest in stocks, bonds, notes and other interest bearing securities, which $800. of income would have been, as a personal exemption, eliminated from taxation by Par. Second of Subd. (e) of said Section 3 if he had not received any income other than that derived from said sources (R. 8, 11. Public Act No. 17, Sec. 3, Par. Second, Subd. (e), Subs. Second, quoted at p. 5, *supra*).

The appellant then unsuccessfully sought before the Tax Commissioner and in the courts of Vermont, including the Supreme Court, the highest court of said state in which a decision then could or now can be had, among other things, for a determination that said Public Act No. 17 was invalid on the ground of its being repugnant to the Constitution of the United States in that it abridged his privileges and immunities as a citizen of the United States, deprived him of his property without due process of law, and denied him the equal protection of the laws, contrary to the Fourteenth Amendment of the United States Constitution, and interfered with interstate commerce, contrary to Article I, Section 8 of the United States Constitution.

(e) ASSIGNED ERRORS INTENDED TO BE URGED.
1a, 1c, 1d and 1e.

The said Court (Supreme Court of the State of Vermont) erred in ruling that the provisions of Public Act No. 17 of the Public Act of 1931 of the State of Vermont, known

as the Income and Franchise Tax Act of 1931, which imposed a tax at the rate of 4% on income amounting to $130,875.39 received by the appellant in the year 1931 as dividends or parts thereof on stocks of corporations the income of which was in whole or in such parts not subject to taxation as against such corporations at the rate of 2% under Part II of said Public Act No. 17 because earned without the State of Vermont, but imposed no tax upon the amounts received as dividends or parts thereof on stocks of corporations the income of which was in whole or in such parts subject to taxation as against such corporations at the rate of 2% under Part II of said Act because earned within the State of Vermont,

Did not abridge said appellant's privileges and immunities as a citizen of the United States in violation of the Fourteenth Amendment of the Constitution of the United States, (1a.)

Did not deprive said appellant of his property without due process of law in violation of the Fourteenth Amendment of the Constitution of the United States, (1c.)

Did not deny said appellant the equal protection of the laws in violation of the Fourteenth Amendment of the Constitution of the United States, (1d.)

Did not interfere with interstate or foreign commerce in violation of Section 8 of Article I of the Constitution of the United States. (1e.) (R. 29-31).

2a, 2c, 2d and 2e.

The said Court erred in ruling that the provisions of Public Act No. 17 of the Public Acts of 1931 of the State of Vermont, known as the Income and Franchise Tax Act of 1931, which imposed a tax at the rate of 4% on income amounting to $25,945.00 received by the appellant in the year 1931 as interest on account of money loaned without the State of Vermont, or on account of credits representing the purchase price in whole or in part of real estate without the State of Vermont, bearing interest at a rate of not

exceeding 5% per annum, and evidenced by a promissory note, mortgage on real estate or a bond for a deed, but imposed no tax on income received as interest on account of such a loan within the State of Vermont, or on account of such a credit with respect to real estate within the State of Vermont, bearing such interest and evidenced by such obligations,

Did not abridge said appellant's privileges and immunities as a citizen of the United States in violation of the Fourteenth Amendment of the Constitution of the United States, (2a.)

Did not deprive said appellant of his property without due process of law in violation of the Fourteenth Amendment of the Constitution of the United States, (2c.)

Did not deny said appellant the equal protection of the laws in violation of the Fourteenth Amendment of the Constitution of the United States, (2d.)

Did not interfere with interstate or foreign commerce in violation of Section 8 of Article I of the Constitution of the United States. (2e.) (R. 31-33).

4d.

The said Court erred in ruling that the provisions of Public Act No. 17 of the Public Acts of 1931 of the State of Vermont, known as the Income and Franchise Tax Act of 1931, which imposed a tax at the rate of 4% on $800. of income derived by the appellant from his ownership of and interest in stocks, bonds, notes and other interest bearing securities, but which, by Section 3 of said Public Act No. 17, would have eliminated said $800. of income from taxation, as a personal exemption of a married individual living with his wife, if he had not received any income other than that derived from said sources,

Did not deny said appellant the equal protection of the laws in violation of the Fourteenth Amendment of the Constitution of the United States. (R. 37).

(f) ARGUMENT.

In this Court the appellant presents the following points:

Point I.

Public Act No. 17 in effect taxes interest and dividends earned outside of Vermont and exempts interest and dividends earned within Vermont. It is therefore unconstitutional under the Fourteenth Amendment of the United States Constitution.

Subd. 1. The Statute is *prima facie* unconstitutional.

Subd. 2. The attempted justifications do not sustain the Statute.

Point II.

Public Act No. 17, by discriminating against investment by Vermont residents in no-Vermont stocks and loans, in effect creates an embargo upon the export of capital. It is therefore unconstitutional under the Commerce Clause, Article I, Section 8, of the United States Constitution.

Point III.

The taxes involved cannot stand if the discriminatory exemptions are stricken from the statute as unconstitutional.

Point IV.

Public Act No. 17, by arbitrarily refusing to the appellant the $800. exemption given to other persons whose situation differed from his only in that they had no income from business, denies the appellant the equal protection of the laws. It is therefore unconstitutional under the Fourteenth Amendment of the United States Constitution.

Conclusion.

The judgment of the Supreme Court of Vermont should be reversed and the cause remanded with instructions to annul the assessment of the appellant's tax and to cause the same to be refunded to him.

POINT I.

Public Act No. 17 in effect taxes interest and dividends earned outside of Vermont and exempts interest and dividends earned within Vermont. It is therefore unconstitutional under the Fourteenth Amendment of the United States Constitution.

Subd. 1. The Statute is prima facie unconstitutional.

Pertinent provisions of the Vermont Income and Franchise Tax Act of 1931 are given on pages 3 to 5, *supra.*

It is divided into two parts, Part I and Part II. Part I imposes an income tax on individuals, and Part II imposes a franchise tax on corporations measured by net income.

Part I imposes, in addition to an income tax on income from business, known as "net income", an income tax at the rate of 4% on residents of Vermont upon interest and dividends (Sec. 3, pp. 3-4, *supra*). The Act then proceeds to make two exemptions. The first exempts interest on Vermont loans which do not bear interest at more than 5% per annum[1]. It then exempts an amount of dividends upon the stock of any corporation proportionate to the amount of income upon which the corporation is subject to franchise tax under Part II of the Act[2]. The corporation is taxable under Part II of the Act at the rate of only 2% and then only upon income earned in Vermont[3].

The net effect of this part of the Act therefore is to exempt from this 4% tax interest on money loaned at a rate not exceeding 5% per annum in Vermont and dividends proportionate to profits which the corporation earned in Vermont, and to subject to the 4% tax only such interest on money loaned at a rate less than 5% as is earned upon money loaned outside of Vermont, and only such dividends

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[1]Pt. I, Sec. 3, Par. Second, Subd. (a) thereof.
[2]Pt. I, Sec. 3, Par. Second, Subd. (d) thereof.
[3]Pt. II, Secs. 2, 3 thereof.

as are proportionate to profits which the corporation earns outside of Vermont.

Our position is that these provisions of the Act deprive citizens of the United States of the right to which they are entitled under the Fourteenth Amendment to invest in non-Vermont loans and stocks on at least as favorable terms as they are permitted to invest in Vermont loans and stocks.

Section 1 of the Fourteenth Amendment of the Constitution of the United States reads:

> "Sec. 1. All persons born or naturalized in the United States, and subject to the jurisdiction thereof, are citizens of the United States and of the State wherein they reside. No State shall make or enforce any law which shall abridge the privileges or immunities of citizens of the United States; nor shall any State deprive any person of life, liberty, or property, without due process of law; nor deny to any person within its jurisdiction the equal protection of the laws."

Capricious classifications for purposes of taxation are held invalid as denying to persons the equal protection of the laws. (See, as an instance, *Louisville Gas & Electric Co.* v. *Coleman*, 277 U. S. 32 (1928, *infra*)).

A conclusion that a classification is not capricious is, however, not enough to save it under the equal protection clause. The object of the classification must be legitimate. A statute taxing foreign corporations at a higher rate than similarly situated domestic corporations is void under the equal protection clause even though corporations cannot, like natural persons, be citizens and thus entitled to the protection afforded citizens by the Constitution. In *Hanover Insurance Co.* v. *Harding*, 272 U. S. 492 (1926), the State of Illinois taxed foreign insurance companies on net receipts when domestic insurance companies were required to pay no taxes on such net receipts. The rate of tax on net receipts was much higher than the rate which domestic insurance companies paid on their property and was therefore held unconstitutional under the equal pro-

tection clause. The unanimous opinion of this Court was expressed on that branch of the case by Mr. Chief Justice Taft at page 516 as follows:

> "Under the previous decisions of the Supreme Court of Illinois, when the net receipts were treated as personal property and the assessment thereon as a personal property tax subjected to the same reductions for equalization and debasement, it might well have been said that there was no substantial inequality as between domestic corporations and foreign corporations, in that the net receipts were personal property acquired during the year and removed by foreign companies out of the State, and could be required justly to yield a tax fairly equivalent to that which the domest' companies would have to pay on all their personal property, including their net receipts or what they were invested in. It was this view, doubtless, which led to the acquiescence by the state authorities and the foreign insurance companies in such a construction of § 30, and in the practice under it. But an occupation tax imposed upon 100 per cent. of the net receipts of foreign insurance companies admitted to do business in Illinois, is a heavy discrimination in favor of domestic insurance companies of the same class and in the same business, which pay only a tax on the assessment of personal property at a valuation reduced to one-half of 60 per cent. of the full value of that property. It is a denial of the equal protection of the laws."

Still more clearly repugnant to the Fourteenth Amendment, however, is a classification for purposes of taxation which not only has no legitimate object but is deliberately designed to abridge a privilege of a citizen of the United States. For example, a classification which might not be so oppressive as to be unconstitutional under the equal protection clause alone might be unconstitutional if, in addition to lacking any sound foundation in justice, it also discriminated against a privilege of a citizen of the United States.

As was said by Mr. Justice Butler in *Hamilton* v. *Regents of the University of California*, 293 U. S. 245, 261 (1934):

> "The 'privileges and immunities' protected are only those that belong to citizens of the United States as distinguished from citizens of the States—those that arise from the Constitution and laws of the United States as contrasted with those that spring from other sources."

The concept of privileges of citizens of the United States is one which has developed since the foundation of the Republic. It is even said that prior to the adoption of the Fourteenth Amendment there were no citizens of the United States. (*Sharon* v. *Hill*, 26 Fed. 337, 343 (Circuit Court, D. Cal. 1885)). Before the result of the Civil War had more closely welded the Union into a single nation, statesmen were much more deeply concerned with preventing states from abridging the due privileges of citizens of other states than with preventing them from abridging the due privileges of citizens of their own who later came to constitute members of the class of citizens of the United States.

Article IV, Section 2, of the United States Constitution as originally adopted provided that the citizens of each state should be entitled to all the privileges and immunities of citizens in the several states. Under that clause, citizens of other states were able to come into Vermont and invest their funds upon equal terms with the citizens of Vermont without interference by its legislature. (See *Chalker* v. *Birmingham and Northwestern Railway Co.*, 249 U. S. 522 (1919), *infra*).

Upon the adoption of the Fourteenth Amendment citizens of Vermont became *ipso facto* citizens of the United States as well and it is our position that they thereby became entitled to go into other states and invest their funds without being subjected by the legislature of Vermont to any greater burdens than it placed upon their investment of money within its borders.

The states were originally required to give to the citizens of other states the privileges accorded their own citizens. By the Fourteenth Amendment they were required to give to their own citizens such rights as were necessary for the enjoyment of the status of a citizen of the United States.

There can be no doubt that the right to employ funds in any state of the Union on equal terms with citizens of that state and unhampered by restrictions imposed by the state of which the investor is a citizen is one of the essential rights of citizenship in the United States. If we have no such right, the citizenship in the United States created by the Fourteenth Amendment was a citizenship subject to the sovereignty of the states over their citizens. That cannot be. If there is a paramount sovereign of the citizen, it is the United States.

State lines are used by Public Act No. 17 as the basis of a classification hostile to investment in enterprises in sister states. What the state has done in effect is to announce that income over which Vermont has territorial jurisdiction shall be tax free and income over which Vermont has no territorial jurisdiction, but only a jurisdiction through the residence of the owner, shall be taxed. This is not the usual case of a classification invalid because capricious and without logical basis. Its basis is extremely logical but wholly vicious and repugnant to the Fourteenth Amendment and to the whole theory of our union of states. Of all the classifications that might have been chosen for the purposes of taxation, the most clearly unconstitutional is that which exempts intra-state income and taxes extra-state income.

It is settled that the right to do business upon payment of a certain amount as a privilege tax is one of the privileges and immunities of the citizens of the state levying the tax which is assured to citizens of other states by Article IV, Section 2, of the United States Constitution, providing that the citizens of each State shall be entitled to all Privileges and Immunities of Citizens in the several States. That

was the holding in *Chalker* v. *Birmingham and Northwestern Railway Co.*, 249 U. S. 522 (1919, *supra*). In that case there was involved the constitutionality of a statute of the State of Tennessee imposing an annual tax for the privilege of doing work within the state, which amounted to $25 if the chief office of the person or corporation doing the work were in the State of Tennessee, and to $100 if it were not. This Court held that the statute was unconstitutional on the ground that it violated Section 2 of Article IV of the Constitution, since it was a fair presumption that the person whose chief office was in the State of Tennessee and who had to pay $25 would be a citizen of Tennessee, and that the person whose chief office was not within the State of Tennessee and who had to pay $100 would not be a citizen of Tennessee. Mr. Justice McReynolds in delivering the Court's unanimous opinion said at page 527:

> "As the chief office of an individual is commonly in the State of which he is a citizen, Tennessee citizens engaged in constructing railroads in that State will ordinarily have their chief offices therein, while citizens of other States so engaged will not. Practically, therefore, the statute under consideration would produce discrimination against citizens of other States by imposing higher charges against them than citizens of Tennessee are required to pay. We can find no adequate basis for taxing individuals according to the location of their chief offices—the classification, we think, is arbitrary and unreasonable. Under the Federal Constitution a citizen of one State is guaranteed the right to enjoy in all other States equality of commercial privileges with their citizens; but he cannot have his chief office in every one of them."

The holding of the *Chalker* case was that under Section 2 of Article IV of the Constitution a state cannot discriminate against citizens of other states by making the location of one's principal place of business within or without the state the deciding factor in determining whether the tax for exercising privileges within the state shall be the minimum or the maximum.

Where, as in the case at bar, a state discriminates not against citizens of another state but against such of its own citizens as invest in other states, it is submitted that the Fourteenth Amendment constitutes an equally effective protection. The citizen is not only denied the equal protection of the laws but his privileges and immunities as a citizen of the United States are abridged.

In most of the cases where it has been urged that statutes are unconstitutional because of discriminatory classification, the attack has been based upon the equal protection clause. As early as 1912, the equal protection clause was invoked in a case much like the case at bar, with the question left undecided because the plaintiff was not a member of the class alleged to have been discriminated against in the classification. The case was *Darnell* v. *Indiana*, 226 U. S. 390 (1912). There an individual held shares in a Tennessee corporation and the State of Indiana taxed the shares as those of a foreign corporation but at the same time exempted the shares of domestic corporations when their property was taxed to the corporation itself. This Court held that the owner of shares in a foreign corporation could not complain unless he was less favorably treated than the owner of shares in a similarly situated domestic corporation and that the Tennessee corporation was treated precisely like an Indiana corporation which had no property in Indiana. The question of the validity of the statute as taxing the shares of foreign corporations which had property within Indiana and exempting the shares of domestic corporations which had property within Indiana was expressly reserved, Mr. Justice Holmes using the following language in the Court's unanimous opinion (p. 398):

> "The case is pretty nearly disposed of by *Kidd* v. *Alabama*, 188 U. S. 730, where the real matter of complaint, that the property of the corporation presumably is taxed in Tennessee, is answered. See also *Wright* v. *Louisville & Nashville R. R. Co.*, 195 U. S. 219, 222. But it is said that the former decision does

> not deal with the objection that the statutes work a discrimination against stock in corporations of other States contrary to principles often recognized. *I. M. Darnell & Son Co.* v. *Memphis*, 208 U. S. 113. The most serious aspect of this objection is that the statutes of Indiana do not make allowance if a foreign corporation has property taxed within the State. But as to this it is enough to say that, however the statutes may be construed in a case of that sort, the plaintiffs in error do not show that it is theirs, and that as they do not belong to the class for whose sake the constitutional objection would be given, if it would, they cannot complain on that ground."

Thus a question very like that raised in the case at bar was reserved by this Court as presenting a "serious aspect" of "the objection that the statutes work a discrimination against stock in corporations of other States" contrary to the equal protection clause.

In 1920, however, this Court decided a case which seems to us to have gone so much farther than a decision against the statute in the *Darnell* case, that there can no longer be any doubt of the invalidity of a statute taxing the shares of a foreign corporation and exempting the shares of a similarly situated domestic corporation. The case is *F. S. Royster Guano Co.* v. *Virginia*, 253 U. S. 412 (1920, *infra*). In that case this Court held unconstitutional under the equal protection clause a Virginia statute which taxed domestic corporations on both intra-state and extra-state profits if they did any business within the state but did not tax domestic corporations on their extra-state profits if they did no business within the state. Mr. Justice Pitney, speaking for the Court, said at page 416:

> "Their business (that of domestic corporations doing business both within and without the state) done within the State presumably is of some general benefit to the State, certainly enriches its treasury by the amount of the taxes they pay upon the income derived therefrom; and the imposition upon them under c. 472 of taxes not only upon this income but also

upon income that they derive from business conducted outside of the State (similar income of the favored corporations being exempted) has the effect of discriminating against them for that which ought to operate if at all in their favor. It is obvious that the ground of difference upon which the discrimination is rested has no fair or substantial relation to the proper object sought to be accomplished by the legislation."

The discrimination in that case favored extra-state business and involved only a domestic corporation, the creature of the taxing state. Yet it was condemned as denying the equal protection of the laws. In the case at bar the discrimination favors business within the state and discriminates against a natural born citizen of the United States. It is submitted that the discrimination in the case at bar is *a fortiori* unconstitutional.

Although we have been discussing the case at bar as though the dividends taxed by Public Act No. 17 and the extra-state earnings of the corporation were but different forms of the same thing, we realize that the connection between them is somewhat indirect. The earnings which are made determinative of the taxability of the dividends are the earnings of the corporation made during the year in which the dividends are paid to the shareholder. Of course dividends earned in a year when the corporation lost money outside of Vermont but made money within Vermont may be paid during a year when the situation is reversed. In that event, under the terms of the statute, dividends earned within Vermont would be taxed by the State of Vermont and dividends earned outside would be exempted—a result exactly opposite to that which we have treated as the object of the statute. It may well be, therefore, that there is no sufficient ground for our course in treating the dividend question as though extra-state earnings were taxed and intra-state earnings untaxed. We shall continue to treat it on that assumption, however, for, if that is not the basis of the classification in the statute, it has no factual basis at

all and we need go no farther because it is invalid and unconstitutional as purely arbitrary. (*Louisville Gas & Electric Co.* v. *Coleman*, 277 U. S. 32 (1928, *infra*)).

Subd. 2. The attempted justifications do not sustain the Statute.

The Act on its face taxes out-of-state income and exempts intra-state income. It is clearly unconstitutional unless some special justification peculiar to this case can be established.

The rule with respect to the justification of legislative classifications has recently been thus stated by Mr. Chief Justice Hughes, in an opinion concurred in by the majority of this Court, in *Borden's Company* v. *Baldwin*, 293 U. S. 194, 209 (1934):

> "When the classification made by the legislature is called in question, if any state of facts reasonably can be conceived that would sustain it, there is a presumption of the existence of that state of facts, and one who assails the classification must carry the burden of showing by a resort to common knowledge or other matters which may be judicially noticed, or to other legitimate proof, that the action is arbitrary."

With respect to the classification discriminating in favor of intra-state earned interest and against extra-state earned interest, the only state of facts which can be conceived as a basis for it is that the Legislature decided to encourage the loan of money for use in Vermont business. That argument was relied on by the court below (R. 24). It is submitted that the state of facts supposed will not sustain the classification. In fact, the attack which we make upon the statute is made upon this very ground that its purpose is to favor Vermont business as against out-of-state business.

In *F. S. Royster Guano Co.* v. *Virginia*, 253 U. S. 412 (*supra*), a majority of the justices of this Court held

a statute unconstitutional because it imposed no tax on domestic corporations which did no business within the state but imposed a tax upon domestic corporations which did business both within and without the state. This holding was reached in the face of a dissenting opinion by Mr. Justice Brandeis, in which Mr. Justice Holmes concurred, pointing out that the purpose of the classification may have been to encourage local incorporators to incorporate in Virginia rather than go elsewhere even when they were not going to do business in Virginia.

There, if the minority of the Court were correct in their surmise, the state was discriminating in order to make a profit for the commonwealth through the fees of the office of the Secretary of State. Yet the discrimination was not sustained.

Bethlehem Motors Corporation v. *Flynt*, 256 U. S. 421 (1921), is an example of a case where the tendency of a statute to improve the public finances did not serve to keep the statute from unconstitutionality as discriminating against extra-state business with respect to license fees. The statute required a license tax of $500 for the sale of automobiles within the state to be paid by the manufacturer if the manufacturer were within the state and by the dealer if it were not. This tax might be reduced to $100 in any case where proof was made that the manufacturer of the automobiles had invested three-fourths of its entire assets in bonds of the state or its municipalities or in property located and returned for taxation in the state. The statute was attacked as a palpable discrimination against the automobiles of extra-state manufacturers since none of them were likely to have three-fourths of their assets invested in North Carolina state and municipal bonds or in North Carolina property. This Court held the statute unconstitutional under the Fourteenth Amendment as discriminatory.

With respect to the investment in state and municipal bonds, it was contended in this Court by the State of North Carolina that the condition was so impossible of perform-

ance as to be nugatory both with respect to intra-state and extra-state manufacturers. The State Supreme Court, however, regarded it as a real condition and held it a valid one. On that branch of the case, Mr. Justice McKenna said at page 425 for a majority of this Court:

> "We are unable to concur in this conclusion. It is a perilous power to concede to the State, and it is immediately manifest that it can be exerted to prevent all commerce of those corporations (or other corporations) with the State except as the commerce might be through direct personal purchases and importations. In other words, the power can be exerted to exclude the products of those corporations, and every other corporation, if they have, or it has, agents in the state."

The fact that an automobile manufacturer would undoubtedly be aiding the public finances by investing three-fourths of its assets in North Carolina state and municipal bonds was not even referred to as a possible compensation justifying the discrimination.

If a statute's tendency to improve the business of the state itself cannot justify discrimination, certainly a tendency to improve the business of the inhabitants of the state cannot.

This tendency to improve Vermont business is the only basis of which we can conceive for an attempt to justify the discrimination against interest on extra-state loans. There remains the possibility of justification of the discrimination against dividends upon the stock of corporations doing business wholly or partly without the state.

It is urged against us that what the tax with respect to dividends amounts to is an exemption of dividends from taxation where they represent income which has already borne its quota of the support due the state by being taxed at the rate of 2% in the hands of the corporation. The supposed analogy is the exemption of shares of stock from taxation when the property represented by the shares has already been taxed.

But there are at least two ways in which a tax on the property or income of the corporation may fail to justify exemption of the shares or dividends; first, where the property or income has failed to bear its quota because it was not all taxed, and, second, where it has failed to bear its quota because it was not taxed at as high a rate as the shares or dividends would have been. It is our contention that in the case at bar the 2% tax on the corporate income plainly fails to justify the exemption of the dividends from the 4% tax because the income was not taxed at as high a rate as the dividends would have been.

If all of the corporation's property has been taxed and the tax on the property and on the shares are at the same rate, the property has already borne 100% of its quota of the support due the state and an exemption from tax in the hands of the stockholder would be just. If because of the fact that 75% of the property of the corporation is within the state the property has already borne 75% of its quota of the support due the state, there it might be said that every share of stock held by a stockholder represents an aliquot part of property which has borne 75% of its quota. Under those circumstances it was held in *Klein* v. *Board of Supervisors*, 282 U. S. 19 (1930), that a complete exemption in the hands of stockholders is just, but Justice Holmes reached that result in a unanimous opinion of this Court by first approving a supposed case of an exemption of the shares where 100% of the property had already been taxed in the hands of the corporation, and then adding (p. 23):

> "And what would be true in the case supposed would be true when the corporation was paying for the great body of its property although some small fraction happened to be outside of the State. Thus we come to the usual question of degree and of drawing a line where no important distinction can be seen between the nearest points on the two sides, where the distinction between the extremes is plain."

There can fairly be deduced from the above quoted *Klein* case the rule that there are cases where the property of the

corporation has not borne enough of its quota of the burden due the state to justify the exemption of its shares, and on the other hand, that there are cases where the property of the corporation, while it has not borne the full burden due the state, has yet borne all but a small fraction and thereby justifies the exemption of its shares.

We submit that the discrimination in the case at bar is unjustifiable if justifications for discrimination are to be compared mathematically by saying, "In this case the property has borne all but 25% of the due burden. It has thus borne all but a 'small fraction' of what it should and therefore an exemption of the whole of the shares can be justified," or by saying, "The property has borne all but 75% of its due burden. That is a 'large fraction' and therefore exemption of the stock is not justified."

In the case at bar, even if we should regard the tax on the net income of the corporation and the tax on the dividends paid to the stockholders as taxing the same property, that property has borne but 50% of its burden in the hands of the corporation, for the income tax is 4% and the corporation tax is but 2%. The justification for the territorial discrimination in the *Klein* case—the fact that the property had already borne 75%, or all but a "small fraction" of its burden—is not available here. The property has at most borne 50% of its burden.

That is not the most important point, however. Justice Holmes in the *Klein* case went on to say (pp. 23-24):

> "We agree with the Court of Appeals that there could have been no question if the statute had said ninety per cent and that fixing seventy-five was equally plainly 'a reasonable effort to do justice to all in view of the way all our other assessments are made'."

There are no signs of a reasonable effort to do justice to all in the case at bar. The variation in the rate, making that on dividends of the corporation doing business outside the state double that on the income of a corporation

doing business within the state, is, in the words of Mr. Justice McKenna in *Citizens' Telephone Co. v. Fuller*, 229 U. S. 322, 331 (1913), one of those "clear and hostile discriminations between particular persons and classes" which condemns the statute under the equal protection clause.

The discrimination works inexorably in every case. It is not one of those classifications which sometimes works to the advantage of the inhabitants of the state imposing it and sometimes to the advantage of outsiders, as was the effect of the classification sustained in the *Klein* case. There a holder of the shares of a corporation which had only 76% of its property in Kentucky was better off under the Kentucky tax law than one who held stock in a corporation which had all of its property in Kentucky. In the 76% case the total tax of the corporation and stockholder would be imposed on only 76% of the property and the 24% outside would go untaxed by Kentucky, but in the 100% case the total tax would be based on 100% of the property. There is no chance in the case at bar, however, that the 2% tax on the corporation's income and the 4% tax on the stockholder's dividends, coupled with the exemption of the dividends on the stock of corporations which were subject to the 2% tax, could ever work to the advantage of extra-state business. No matter how the other factors vary the differences in rate will always work in favor of Vermont and against the rest of the Union. And when we consider as well the discrimination against money loaned outside of Vermont, we are justified in concluding that this consistent discrimination against dividends of corporations doing business outside of the state was no mere inadvertence.

We concede that a completely fair system of taxation, giving to shares of stock the benefit of taxes paid by the corporation, cannot be devised. There are cases which have been sustained as devices to avoid double taxation where the rate of tax upon the shares was fixed by the terms of the statute and the rate of tax upon the property of the corporation was different because it depended upon the

rate struck by the local assessors in each taxing district, but none of them exhibited the deliberate hostility to out-of-state affairs shown by the statute in the case at bar. (*Travellers' Insurance Co.* v. *Connecticut*, 185 U. S. 364 (1902, Brewer, J.); *Kidd* v. *Alabama*, 188 U. S. 730 (1903, Holmes, J.); *General American Tank Car Corporation* v. *Day*, 270 U. S. 367 (1926, Stone J.)).

Statutes discriminating against out-of-state enterprises cannot be saved by simply pointing out that the favor given intra-state enterprises is given only when their property is taxed within the state. There must be some logical relation between the tax from which the local enterprise is exempted and the tax which the local enterprise pays. Under the statute in *Bethlehem Motors Corporation* v. *Flynt*, 256 U. S. 421 (1921, *supra*), an automobile manufacturer's license tax would be reduced from $500. to $100. if 75% of the manufacturer's property were located and taxed in North Carolina. The North Carolina Attorney General asserted in this Court that there was no discrimination against foreign manufacturers because they could perform the condition as easily as local manufacturers. Mr. Justice McKenna, speaking for a majority of this Court, replied (p. 426):

> "To this we cannot assent. The condition can be satisfied by a resident manufacturer, his factory and its products in the first instance being within the State; it cannot be satisfied by a non-resident manufacturer, his factory necessarily being in another State, some of its products only at a given time being within the State. Therefore, there is a real discrimination, and an offense against the Fourteenth Amendment, if we assume that the corporations are within the State."

The fact that an automobile manufacturer which invested three-fourths of its assets in property taxable in North Carolina would be contributing heavily in taxes was not even referred to as a possible compensation justifying the discrimination.

We feel that we should not leave this subject without calling attention to the fact that verbally, at least, the attempted justification of the exemption from taxation of income earned within the state runs counter to the doctrine of this Court in *First National Bank* v. *Maine*, 284 U. S. 312 (1932). That case applied the rule of single situs for intangible property to shares of stock and held that the state of incorporation could not subject them to inheritance tax in the estate of a non-resident. Mr. Justice Sutherland, speaking for the majority, said, p. 329, "there is wanting, on the part of a state other than that of the domicile, any real taxable relationship to the event which is the subject of the tax." This Court has not yet decided whether that principle that the state cannot measure taxes by matters beyond its jurisdiction does not limit the State of Vermont to merely taxing all of the income or all of the value of the shares of stock of foreign corporations held by Vermont residents and does not prevent the State of Vermont from taxing so much, but no more, of the shares or the income as represents property and activities outside of its borders.

POINT II.

Public Act No. 17, by discriminating against investment by Vermont residents in non-Vermont stocks and loans, in effect creates an embargo upon the export of capital. It is therefore unconstitutional under the commerce clause, Article I, Section 8, of the United States Constitution.

The Commerce Clause furnishes another basis for invalidity of the statute here involved. This is true with respect to the tax on dividends but is clearest with respect to the tax upon interest from loans made outside of Vermont where there is no corresponding tax upon interest from loans made within Vermont. Looking at the question realistically, this tax situation discourages Vermont resi-

dents from making loans outside of Vermont and thus approximates an embargo upon the exportation of capital from Vermont into other states. While this Court in *Northwestern Life Ins. Co.* v. *Wisconsin,* 247 U. S. 132, (1918, Day, J.) reserved the question whether foreign investment business constituted interstate commerce, we submit that there can be no doubt that it should be answered in the affirmative. The decisions of this Court condemn any "burden upon the occupation or the privilege of carrying on (interstate) commerce, whatever may be the instrumentalities or means employed to that end." (*New Jersey Telephone Co.* v. *Tax Board,* 280 U. S. 338, 346 (1930), from prevailing opinion by Mr. Justice Butler). If all of the states are to be permitted to follow the example of Vermont and tax the income from extra-state investments at higher rates than intra-state ones, the development of one part of the country with capital from another part will be at an end.

POINT III.

The taxes involved cannot stand if the discriminatory exemptions are stricken from the statute as unconstitutional.

The point was made below that all that the appellant complained of with respect to the tax on dividends and the tax on interest on loans was the fact that dividends of corporations doing business inside of Vermont and interest on loans made inside of Vermont were exempted from taxation. It was said that if these exemptions were unconstitutional the statute would still stand and would simply tax the extra-state income and the intra-state income too, so that the appellant would gain nothing. This contention was made and conclusively answered in *Lawrence* v. *State Tax Commission,* 286 U. S. 276 (1932). There the Mississippi income tax law was attacked by a resident individual in the contracting business who earned money in

Tennessee. He based his attack on the ground that it exempted income earned by domestic corporations under the same circumstances. The exemption of corporations had been added by an amendment. The court below had held that even if the statute were discriminatory, that merely struck out the amendment and left corporations and individuals taxed alike so that the plaintiff had properly been required to pay the tax in any event. Mr. Justice Stone, on page 282, in a part of the opinion which was concurred in by all of the Justices, answered that if the statute were discriminatory appellant's constitutional rights were infringed when the tax was levied upon him, and state officers acting under the amendment refrained from assessing the like tax upon his corporate competitors."[1]

POINT IV.

Public Act No. 17, by arbitrarily refusing to the Appellant the $800. exemption given to other persons whose situation differed from his only in that they had no income from business, denies the appellant the equal protection of the laws. It is therefore unconstitutional under the Fourteenth Amendment of the United States Constitution.

The statute under consideration deals with two classes of income which it defines: First, what may be referred to as income from business[2] and, second, income from investment.[3] An exemption of $800 is applicable against the

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[1]While the Court thus held that the appellant was entitled to raise the question, it pointed out that the state had adopted generally a policy of avoiding double taxation of the same economic interest in corporate income by taxing the income to the corporation or the dividends to the stockholders, but not both, and sustained the classification as not having been shown to be without rational basis.

[2]Pt. I, Sec. 3, Par. First.

[3]Pt. I, Sec. 3, Par. Second.

investment income *but only if there is no income from business.*[1] No justification for this extraordinary provision has been found. As a basis for classification for tax purposes, it is as arbitrary as the difference in maturities of the loans which in *Louisville Gas & Electric Co.* v. *Coleman*, 277 U. S. 32 (1928, *infra*), was held to be an unconstitutional basis.

One of the strangest things about this $800. exemption is that it is so phrased that in the case at bar the appellant has been forced to trade it for the privilege of taking a loss in his business. The statute refuses to allow the exemption "if either a husband or wife shall receive any income other than that derived from the ownership of, or interest in, any stock, bond, note or other interest-bearing security".[2] The Vermont Supreme Court construed "income" to mean "gross income" and so although the appellant had not received any net income from anything other than the enumerated securities, he was deprived of the exemption because he had received gross income from his business. (R. 25). In this the court sustained the Tax Commissioner, whose official form of return bore the legend "26. Personal exemption (not allowed if in receipt of ANY class A income)." (R. 6A).

In spite of its extraordinary character, this provision, refusing the benefit of the exemption from investment income if there was any income from business, is surprisingly like the condemned provision in *W. S. Royster Guano Co.* v. *Virginia*, 253 U. S. 412, *supra*, refusing to domestic corporations the benefit of an exemption from income tax on extra-state earnings if they did any business within the state. It was thought by the minority of the Justices in the *Royster* case that there existed in that case the motive of bringing in more revenue to the office of the Secretary of State and that that motive was a sufficient basis for the classification. Here a basis for the classification cannot be even suggested.

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[1] Pt. I, Sec. 3, Par. Second, Subd. (e) and Subs. Second thereof.
[2] Pt. I, Sec. 3, Par. Second, Subd. (e) and Subs. Second thereof.

CONCLUSION.

The judgment of the Supreme Court of Vermont should be reversed and the cause remanded with instructions to annul the assessment of the appellant's tax and to cause the same to be refunded to him.

To us, the provisions discriminating against extra-state activities seem to embody so much of the spirit of the statute that the statute cannot survive their amputation. We do not think that even its severability clause can save it. That clause is quoted below:

> "Sec. 26. *Construction.* If any provisions of this act or application thereof to any taxpayer or circumstances be held invalid, the validity of the remainder of the act and of the application of such provision to any other taxpayer and circumstances shall not be affected thereby."

But even if the remainder of the statute should be held to have life without the provisions taxing dividends and interest earned at rates not exceeding 5%, there would not be enough left to justify any tax against the appellant. A glance at his income tax return (R. 6A) shows that his only income taxable under the original terms of the statute consisted of dividends and interest. Upon a holding that the tax on dividends was unconstitutional, it would, in effect, be stricken from the Act and his liability for that part of the tax would completely disappear. Upon a holding that the tax upon interest earned outside of Vermont at rates not exceeding 5% was unconstitutional, that would also be stricken from the Act and his liability for the tax upon interest earned at those rates would disappear. The exemption of such interest earned within Vermont would, however, stand (see *supra*, pp. 28-29) and all that would be left of the statute would be a tax on all interest earned at rates exceeding 5%.

The provisions of the law taxing interest which would be left—provisions which would tax only such interest as was earned at rates exceeding 5%—would themselves be invalid as a capricious classification of the subjects of taxation. In *Louisville Gas & Electric Co.* v. *Coleman*, 277 U. S. 32 (1928, *supra*), the question whether a statute which required a recording fee in the case of the recording of mortgages with a term of five years or more but required none in the case of those with terms of less than five years, was held to deny to the holder of a long term mortgage the equal protection of the laws. The state contended, among other things, that the recording fee was not a tax but this Court answered that recording was so necessary that the fee constituted a tax. In holding the statute discriminatory, Mr. Justice Sutherland said for the majority at page 38:

> "Whether the tax now in question be called a privilege tax or a property tax, it falls in effect upon one indebtedness and not upon another where the sum of each is the same; where both are incurred by corporations or both by natural persons; where the percentage of interest to be paid is the same; where the mortgage security is identical in all respects; where, in short, the only difference well may be that one is payable in 60 months and the other in 59 months. No doubt the state may take into consideration as an element in fixing the *amount* of the tax the time within which the indebtedness is to be paid; for, since the tax is a flat sum covering the entire life of the lien, the privilege of recording the short-time lien and that of recording the long-time lien have different taxable values."

It is true that the Court's opinion pointed out that the exemption did not depend upon a difference between the rates of interest borne by the mortgages which were recorded gratis and by those which were recorded on payment of a fee, but we submit that a distinction between 5% and 5¼% as a basis for exemption or taxability is as arbitrary as the distinction between a maturity of 59

months and one of 60 months. In either case under the doctrine of the *Louisville* case the distinction might be made the basis for a difference in a rate of tax but not for an exemption from taxation.

The statute in the case at bar, therefore, will not serve even to tax the appellant upon the interest earned at rates exceeding 5%.

Respectfully submitted,

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